



[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9612]

RIN 1545-BA53

Noncompensatory Partnership Options; Correction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains corrections to final regulations (TD 9612) that were published in the **Federal Register** on Tuesday, February 5, 2013 (78 FR 7997) relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. The final regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The final regulations also modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. The final regulations also contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances.

DATES: This correction is effective on **INSERT DATE OF PUBLICATION OF**

**THIS DOCUMENT IN THE FEDERAL REGISTER** and is applicable on or after February 5, 2013.

FOR FURTHER INFORMATION CONTACT: Benjamin Weaver, at (202) 622-3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### **Background**

The final regulations that are the subject of this document are under sections 171, 704, 721, 761, 1272, 1273, and 1275 of the Internal Revenue Code.

### **Need for Correction**

As published, the final regulations (TD 9612) contain errors that may prove to be misleading and are in need of clarification.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Correction of Publication**

Accordingly, 26 CFR part 1 is corrected by making the following correcting amendments:

### **PART 1-INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.704-1 is amended by revising the table in paragraph (b)(5) Example 35(ii), and the first sentence of paragraph (b)(5) Example 35(iii) to read as follows:

§1.704-1 Partner's distributive share.

\* \* \* \* \*

(b) \* \* \*

(5) \* \* \*

Example 35. \* \* \*

(ii) \* \* \*

	K		L		M	
	Tax	Book	Tax	Book	Tax	Book
Initial capital account	\$10,000	\$10,000	\$10,000	\$10,000	0	0
Year 1 net income	\$1,000	\$1,000	\$1,000	\$1,000	0	0
Year 2 net income	\$1,000	\$1,000	\$1,000	\$1,000	0	0
Year 3 net income	<u>\$1,000</u>	<u>\$1,000</u>	<u>\$1,000</u>	<u>\$1,000</u>	<u>0</u>	<u>0</u>
Year 4 initial capital account.....	\$13,000	\$13,000	\$13,000	\$13,000	0	0

(iii) At the beginning of Year 4, at a time when property D, LLC's only asset, has a value of \$33,000 and basis of \$24,000 (\$30,000 original basis less \$6,000 depreciation in Years 1 through 3), and LLC has accumulated undistributed cash of \$12,000 (\$15,000 gross income less \$3,000 of interest payments) in LLC, M converts the debt into a 1/3 interest in LLC. \* \* \*

\* \* \* \* \*

Par. 3. Section 1.761-3 is amended by:

- a. Revising the second sentence of paragraph (b)(3);
- b. Revising paragraph (f) introductory text;
- c. Removing "1" from paragraph (f) Example heading; and
- d. Revising the second sentence in the paragraph (f) Example.

The revisions read as follows:

§1.761-3 Certain option holders treated as partners.

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \* In addition, an option includes convertible debt (as defined in §1.721-2(g)(2)) and convertible equity (as defined in §1.721-2(g)(3)). \* \* \*

\* \* \* \* \*

(f) Example. The following example illustrates the provisions of this section. For purposes of the example, assume that PRS is a partnership for Federal tax purposes, none of the noncompensatory option holders or partners are related persons, and that general principles of law do not apply to treat the noncompensatory option as a partnership interest. The example reads as follows:

Example. \* \* \* In exchange for a premium of \$10x, PRS issues a noncompensatory option to A to acquire a 10 percent interest in PRS for \$110x at any time during a 3-year period commencing on the date on which the option is issued. \* \* \*

\* \* \* \* \*

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